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REPORT
No. 98-14

PAYMENT-IN-KIND TAX TREATMENT ACT OF 1983

MARCH 2, 1983.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 1296]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 1296) to amend the Internal Revenue Code of 1954 to allow any taxpayer to elect to treat for income tax purposes any crop received under a Federal program for removing land from agricultural production as produced by the taxpayer, to allow any taxpayer to elect to defer income on any cancellation under such a program of any price support loan, and to provide that participation in such a program shall not disqualify the taxpayer for the special use valuation of farm real property under section 2032A of such Code, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Payment-in-Kind Tax Treatment Act of 1983".

SEC. 2. INCOME TAX TREATMENT OF AGRICULTURAL COMMODITIES RECEIVED UNDER A 1983 PAYMENT-IN-KIND PROGRAM.

(a) INCOME TAX DEFERRAL, ETC.—Except as otherwise provided in this Act, for purposes of the Internal Revenue Code of 1954—

(1) a qualified taxpayer shall not be treated as having realized income when he receives a commodity under a 1983 payment-in-kind program,

(2) such commodity shall be treated as if it were produced by such taxpayer, and

(3) the unadjusted basis of such commodity in the hands of such taxpayer shall be zero.

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(b) EFFECTIVE DATE.—This section shall apply to taxable years ending after December 31, 1982, but only with respect to commodities received for the 1983 crop year.

SEC. 3. LAND DIVERTED UNDER 1983 PAYMENT-IN-KIND PROGRAM TREATED AS USED IN FARMING BUSINESS, ETC.

(a) GENERAL RULE.—For purposes of the provisions specified in subsection (b), in the case of any land diverted from the production of an agricultural commodity under a 1983 payment-in-kind program—

(1) such land shall be treated as used during the 1983 crop year by the qualified taxpayer in the active conduct of the trade or business of farming, and

(2) any qualified taxpayer who materially participates in the diversion and devotion to conservation uses required under a 1983 payment-in-kind program shall be treated as materially participating in the operation of such land during such crop year.

(b) PROVISIONS TO WHICH SUBSECTION (a) APPLIES.—The provisions specified in this subsection are—

(1) section 2032A of the Internal Revenue Code of 1954 (relating to valuation of certain farm, etc., real property),

(2) section 6166 of such Code (relating to extension of time for payment of estate tax where estate consists largely of interest in closely held business),

(3) chapter 2 of such Code (relating to tax on self-employment income), and

(4) title II of the Social Security Act (relating to Federal old-age, survivors, and disability insurance benefits).

SEC. 4. ANTI-ABUSE RULES.

(a) GENERAL RULE.—In the case of any person, sections 2 and 3 of this Act shall not apply with respect to any land acquired by such person after February 23, 1983, unless such land was acquired in a qualified acquisition.

(b) QUALIFIED ACQUISITION.—For purposes of this section, the term "qualified acquisition" means any acquisition—

(1) by reason of the death of a qualified transferor,

(2) by reason of a gift from a qualified transferor, or

(3) from a qualified transferor who is a member of the family of the person acquiring the land.

(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) QUALIFIED TRANSFEROR.—The term "qualified transferor" means any person—

(A) who held the land on February 23, 1983, or

(B) who acquired the land after February 23, 1983, in a qualified acquisition.

(2) MEMBER OF FAMILY.—The term "member of the family" has the meaning given such term by section 2032A(e)(2) of the Internal Revenue Code of 1954.

(3) MERE CHANGE IN FORM OF BUSINESS.—Subsection (a) shall not apply to any change in ownership by reason of a mere change in the form of conducting the trade or business so long as the land is retained in such trade or business and the person holding the land before such change retains a direct or indirect 80-percent interest in such land.

(4) TREATMENT OF CERTAIN ACQUISITIONS OF RIGHT TO THE CROP.—The acquisition of a direct or indirect interest in 80 percent or more of the crop from any land shall be treated as an acquisition of such land.

SEC. 5. DEFINITIONS AND SPECIAL RULES.

(a) GENERAL RULE.—For purposes of this Act—

(1) 1983 PAYMENT-IN-KIND PROGRAM.—The term "1983 payment-in-kind program" means any program for the 1983 crop year—

(A) under which the Secretary of Agriculture (or his delegate) makes payments in kind of any agricultural commodity to any person in return for—

(i) the diversion of farm acreage from the production of an agricultural commodity, and

(ii) the devotion of such acreage to conservation uses, and

(B) which the Secretary of Agriculture certifies to the Secretary of the Treasury as being described in subparagraph (A).

(2) 1983 CROP YEAR.—The term "1983 crop year" means the crop year for any crop the harvesting or planting period for which occurs during 1983.

(3) QUALIFIED TAXPAYER.—The term "qualified taxpayer" means any producer of agricultural commodities (within the meaning of the 1983 payment-in-kind

programs) who receives any agricultural commodity in return for meeting the requirements of clauses (i) and (ii) of paragraph (1)(A).

(4) RECEIPT INCLUDES RIGHT TO RECEIVE, ETC.—A right to receive (or other constructive receipt of) a commodity shall be treated the same as actual receipt of such commodity.

(5) COMMODITY CREDIT LOANS TREATED SEPARATELY.—Subsection (a) of section 2 shall apply to the receipt of any commodity under a 1983 payment-in-kind program separately from, and without taking into account, any related transaction or series of transactions involving the satisfaction of loans from the Commodity Credit Corporation.

(b) REGULATIONS.—The Secretary of the Treasury or his delegate (after consultation with the Secretary of Agriculture) shall prescribe such regulations as may be necessary to carry out the purposes of this Act, including (but not limited to) such regulations as may be necessary to carry out the purposes of this Act where the commodity is received by a cooperative on behalf of the qualified taxpayer.

SEC. 6. STUDY.

(a) GENERAL RULE.—The Secretary of the Treasury or his delegate, after consultation with the Secretary of Agriculture, shall conduct a study of—

(1) the 1983 payment-in-kind program, and

(2) the tax treatment provided with respect to such program by this Act.

(b) REPORT.—Not later than September 1, 1983, the Secretary of the Treasury shall submit to the Congress a report on the study conducted under subsection (a), together with such recommendations as he may deem advisable.

SEC. 7. TREATMENT OF CERTAIN AGRICULTURAL ORGANIZATIONS.

(a) GENERAL RULE.—Any agricultural organization described in subsection (b) (and any affiliate of such organization) shall be treated for purposes of the Internal Revenue Code of 1954 as described in section 501(c)(5) of such Code so long as such organization (or affiliate)—

(1) is operated on a nonprofit basis primarily for collective bargaining with respect to unprocessed agricultural commodities produced by its members,

(2) does not engage in any substantial processing activities, and

(3) in its marketing activities—

(A) acts solely as agent for its members, and

(B) returns in cash to its members not less than 90 percent of the proceeds of the sales of the commodities.

(b) ORGANIZATIONS TO WHICH SUBSECTION (a) APPLIES.—An organization is described in this subsection if—

(1) such organization is an agricultural organization organized in 1955, and

(2) such organization was ruled by the Internal Revenue Service to be exempt from tax under section 501(c)(5) of such Code in 1957.

(c) EFFECTIVE DATE.—This section shall apply to taxable years beginning after December 31, 1983.

Amend the title so as to read:

A bill relating to the treatment for income and estate tax purposes of commodities received under 1983 payment-in-kind programs, and for other purposes.

I. SUMMARY

A. Summary of the Bill

PIK Tax Treatment Provisions

The Department of Agriculture has adopted a payment-in-kind (PIK) program under which farmers are paid with commodities for diverting all or certain portions of their farmland from production.

Under the committee bill, recognition of income from commodities received in the 1983 PIK Program will be deferred from the date the commodities are received (or constructively received) until the date on which the commodities are sold.

Real property withdrawn from the production in exchange for a payment-in-kind under the 1983 PIK Program will be treated as used in an active farming (e.g., qualified) use by the person entering the PIK contract for purposes of the Federal estate tax current use valuation and installment payment provisions. Additionally, an individual who materially participates in the conservation use to which real property withdrawn from production under the 1983 PIK Program is devoted will be treated as materially participating in a farming operation in which the PIK property is used.

The committee bill generally will treat income from PIK commodities as active income derived from the business of farming for all purposes under the Internal Revenue Code.

For purposes of the self-employment income (SECA) tax the social security benefit provisions and income tax credits, income from PIK commodities will be treated as "earned" income to persons who materially participate in the conservation use to which the PIK real property is devoted.

Rules are provided treating commodities received under a PIK program by a cooperative as patronage source income from the sale of commodities produced by the cooperative's patrons.

The committee bill also includes a special anti-speculation rule that limits the income and estate tax provisions to land acquired by any person before February 24, 1983, unless the acquisition occurs by reason of death, by reason of gift, or from a member of the transferee's family. Mere changes in form are not treated as transfers if the transferor retains at least a direct or indirect 80-percent interest in the land. Under this rule, acquisition of an 80-percent or more interest in a crop from any land is treated as acquisition of the land.

Finally, a study of the effects of the PIK program and the tax treatment under the committee bill is required from the Secretary of the Treasury no later than September 1, 1983.

The income tax provisions of the committee bill apply to PIK payments for the 1983 crop year, including PIK payments for crops normally harvested or planted on or before December 31, 1983. The

estate tax provisions apply to real property withdrawn from production in respect of such payments.

Exemption of Certain Agricultural Organizations

The committee bill also exempts from tax certain agricultural organizations operated on a nonprofit basis primarily as a collective bargaining agent with respect to the marketing of unprocessed agricultural commodities produced by their members, effective for taxable years beginning after December 31, 1983.

The beneficiary of this provision is intended to be the National Farmers Organization.

B. Legislative History of H.R. 1296

H.R. 1296 was introduced and referred to the Committee on Ways and Means on February 7, 1983. On February 15, 1983, the bill was referred to the Subcommittee on Select Revenue Measures, which conducted a public hearing on February 23, 1983. On February 23, 1983, the Subcommittee unanimously ordered the bill favorably reported to the full Committee, with an amendment in the nature of a substitute. The Subcommittee transmitted its report to the full Committee on February 28, 1983. The Committee on Ways and Means approved the bill without further amendment on March 1, 1983.

II. EXPLANATION OF THE BILL

A. Tax Treatment of the PIK Program

Description of the Payment-in-Kind ("PIK") Program

Overview

The Department of Agriculture's payment-in-kind ("PIK") program is a program for diverting from production land which otherwise would be used to produce crops of wheat, corn, sorghum, rice, and upland cotton. Under the program, producers will be provided a quantity of a commodity as compensation for diverting acreage normally planted in that commodity. As presently announced, the PIK program applies only for the 1983 acreage reduction program.

The PIK program is in addition to the previously established acreage reduction and price support programs available to farmers. The previous programs provide for cash, rather than in-kind, payments. Farmers must be participants in these cash payment programs as a condition of eligibility for the PIK program.

PIK Program

General rules.—Under the PIK program, farm producers generally may elect to divert from 10 to 30 percent of their crop acreage base [1] from active crop production in exchange for a payment-in-kind equal to an established quantity of the commodity normally grown on the property. The established percentage is the farm's program yield [2] times 95 percent for wheat and 80 percent for corn, grain, sorghum, upland cotton, and rice multiplied by the PIK acreage.

In lieu of the guaranteed 10 to 30 percent PIK diversion election, farmers may elect to divert the whole crop acreage base (other than property in the cash diversion program) for the farm on a bid basis. If a whole crop bid is made, the farmer offers to reduce his or her planted acreage of the crop to zero. As part of his or her bid, the farmer specifies the percent of the farm's program yield that he or she will accept as compensation. The lowest bids will be accepted first. If the whole base bid is accepted, the bid compensation rate applies to the entire PIK acreage. If the whole base bid is not accepted, the farmer is still entitled to PIK diversion of 10 to 30 percent of his or her crop acreage base at the established compensation rate for the crop involved.

Whether whole base PIK bids will be accepted depends on the amount of propery for which PIK elections are made in the county

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[1] The term "crop acreage base" means the acreage devoted to production of the crop involved during a base period. The crop base is presently established under the Omnibus Reconciliation Act of 1982.

[2] The term "farm program yield" means the yield of the crop covered by a PIK contract on the farm property during an established historical reference period.

where the property is located. The total acreage withdrawn from production of a crop under all Federal Government land diversion programs cannot exceed 50 percent of the total acreage base for the crop in any county. All 10 to 30 percent elections will be accepted before any whole base bids are accepted.

If a farmer has a crop base in more than one crop included in the PIK program, he or she may elect to utilize the program for any combination or all of the crops. The total crop base diverted cannot, however, exceed the total acreage comprising the farm.

Property withdrawn from crop production under the PIK program must be devoted to conservation uses. Generally, this will result in the property being planted with a cover crop to prevent erosion and otherwise being permitted to lie fallow. The PIK acreage may be grazed other than during the six principal growing months of the PIK crop. Harvesting of any crop from land diverted under the PIK program generally will be prohibited.

Applications for both the guaranteed percentage PIK program and the whole base bid program must be submitted by March 11, 1983. All 1983 contracts must be signed by March 17, 1983. Whole base bids will be accepted or rejected at public county meetings on March 18, 1983. Executed PIK contracts are transferable by the farmer under certain circumstances; however, failure to comply with the contract terms can result in forfeiture of payments and, in certain cases, in liquidated damages.

Payment procedures.—Participating farmers will be eligible for payment-in-kind on a date established for their locality. The payment dates range from June 1 for wheat in certain Southern areas to November 1 for corn in certain Northern States. The payment availability dates reflect the usual harvest dates of PIK crops in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

The PIK commodities will be paid from surplus commodities held by the Federal Government. The Federal Government acquires these commodities through loan cancellations in the crop loan and price support programs administered by the Commodity Credit Corporation ("CCC") [3] and the Farmer-owned Reserve ("FOR").[4] The CCC and FOR programs are similar, except CCC loans are normally made for a 9-month period while FOR stocks generally are held off the market for 3 years. In the case of payment from farm-stored FOR stocks, farmers will be paid an additional 7 months of storage costs beyond the normal 5 months allowed under the PIK program.

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[3] The CCC is a Federally owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for Government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

[4] A portion of the commodities will be acquired through transactions, the substance of which is loan cancellation, with farmers who have such loans outstanding immediately before they receive payments of commodities under the PIK program.

The method of payment under the PIK program will vary, depending on whether the farmer has outstanding loans with the CCC or has grain in the FOR. If the farmer has no commodities pledged under these programs, he or she will receive payment from Government stocks of the commodity involved. If the farmer has commodities pledged under either of the programs, the payment will take the form of a 3-step transaction. First, the farmer will repay an amount of his outstanding loans equal to the PIK payment.[5] At that time, a pro rata portion of the loan security will be released. Second, the Government will repurchase the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and storage charges paid by the farmer on repayment of the loan). Finally, the Government will return the commodities to the farmer as a payment-in-kind under the PIK contract.

Special procedures for upland cotton and rice.—PIK payments of upland cotton and rice generally will be made by the Government to a farmer's cooperative. If an upland cotton or rice producer markets his or her crop through a cooperative, the cooperative will receive the payment otherwise due the farmer under the PIK contract. Other farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives will be the same as for individual farmers dealing directly with the Government. PIK payments to cooperatives will be held in pools separate from other crops held by the cooperatives.

Cash payment acreage reduction program

As stated in the Overview, farmers must participate in the cash payment acreage reduction program as a prerequisite of eligibility for the PIK program. This cash diversion program consists of two facets. First, the farmer must divert from production an established percentage of his or her acreage base in exchange for diversion payments.[6] This required percentage varies with the crop—wheat, feed grains, corn, rice, and upland cotton. The payment is a statutorily prescribed amount per crop unit times the farm program payment yield for each acre diverted.

Second, the farmer must divert from production an additional percentage of his or her otherwise planted crop acreage for no pay. As with the so-called paid diversion, this no pay percentage varies with the crop involved (e.g., 12½ percent of planted acreage for corn at the present time). These two diversion requirements generally result in approximately 20 percent of the farmer's crop acreage base being withdrawn from production in addition to any land so withdrawn under the PIK program. As with acreage in the PIK program, property withdrawn under the cash payment program must be devoted to conservation use.

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[5] Except in the case of upland cotton, the farmer can choose which loans to repay. Cotton loans must be repaid in the order in which the crops under loan were produced.

[6] The Omnibus Reconciliation Act of 1982 authorized advance payment of prescribed percentages of payments for 1982 and 1983 crops (normally made in 1983 and 1984) during 1982. Additional advance payments for 1983 crops (normally made in 1984) are permitted in 1983. Advance payments are made at the option of the farmer.

Participation in the cash payment program also entitles the farmer to deficiency (price-support) payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price.

Present Law

1. Income tax treatment of farmers

a. Timing of income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than $1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

Under the cash method of accounting, income is recognized for the year in which it is actually or constructively received. Income is constructively received by a taxpayer when it is credited to his or her account, set apart for him or her, or otherwise made available so that he or she may draw upon it at any time (Treas. Reg. sec. 1.451–2(a)). A taxpayer who uses the cash method of accounting must recognize income when he or she is entitled to receive commodities under a payment-in-kind program.

Under the accrual method of accounting, income is generally recognized when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when received (Treas. Reg. sec. 1.451). A taxpayer who uses the accrual method of accounting must recognize income when he or she has the right to receive commodities under a payment-in-kind program, regardless of the time of actual receipt.

Thus, under both the cash and accrual methods of accounting, the taxpayer will recognize income when the commodities are made available to the farmer. In addition, under both methods, when property rather than cash is received, the amount to be included in income is the fair market value of the property on the date the taxpayer recognizes the income.

A taxpayer may elect to consider amounts received as loans from the CCC as income in the year in which received (Code sec. 77). If the election is made, the taxpayer takes a basis in the crop equal to the amount included in income. If the commodity securing such loan is later forfeited, no income would be recognized at the time of such forfeiture to the extent of such basis.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding from income the amount of the debt discharged (Code sec. 108) with a corresponding reduction in the basis of certain assets (Code sec. 1017).

A farmer, who has commodities pledged for outstanding loans under the CCC or FOR programs, generally will receive his or her pledged commodity as a payment-in-kind under the PIK contract

with a corresponding reduction in the amount of the CCC or FOR loan. However, as indicated in the discussion of the PIK program this result will be achieved through a three-step process under which the loans are first repaid, followed by a purchase by the Federal Government of the commodity, and then a payment-in-kind of that commodity. It is unclear, under present law, whether such series of transactions would be treated as discharge of indebtedness or would follow the form of the transaction and be treated as a repayment of the loan by the farmer, a sale of the commodity to the CCC, and a return of the commodity to the farmer as a payment-in-kind.

b. Time for payment of tax

In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax would be considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (Code secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates would apply to taxable years beginning on a date other than January 1st. However, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66⅔ percent of the tax liability for the year (Code sec. 6654(d)).

c. Soil and water conservation expenditures

Under present law, a taxpayer engaged in the business of farming may expense amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming (Code sec. 175). The maximum amount that may be expensed in any taxable year may not exceed 25 percent of the taxpayer's gross income derived from farming during the taxable year. Any amount not deductible in any taxable year because of the 25 percent of gross income limitation may be deducted in succeeding taxable years in the order of time so long as any taxable year's deductions under this provision do not exceed 25 percent of gross income from farming for that taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Under present law, if a taxpayer disposes of farm land which he or she has held for fewer than 10 years, a certain proportion of the gain realized on the disposition is treated as ordinary income (Code sec. 1252). That proportion is the lower of a percentage of the aggregate deductions allowed under sections 175 and 182 for expenditures made with respect to the farm land after 1969, or the excess of the amount realized (or the fair market value) over the adjusted basis of such land. For this purpose, the term "farm land" is land with respect to which deductions have been allowed under sections 175 or 182.

d. Expenditures by farmers for fertilizer, etc.

Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (Code sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.

e. Expenditures by farmers for clearing land

Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (Code sec. 182). However, this deduction for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined). Such expenditures are subject to recapture under section 1252 (see item d, above).

f. Activities not engaged in for profit

Under present law, if an individual or a Subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (Code sec. 183). Under those rules, an activity generally is presumed to be not engaged in for profit unless the activity generates a profit at least two years out of the most recent five-year period.

g. Gain from disposition of property used in farming or farm losses offsetting farm income

Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deduc-

tions which do not result in a tax reduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

h. Qualification of corporations for subchapter S status

Under present law, certain closely held corporations (commonly called "subchapter S corporations") can elect to have their income taxed to the shareholders and not the coroporation, regardless of whether or not it is actually distributed during the year (Code secs. 1371–1379).

One requirement for electing subchapter S status for a corporation which had accumulated earnings and profits while it was not a subchapter S corporation is that during the last three taxable years prior to the election no more than 25 percent of the gross receipts of the electing corporation be passive investment income. Passive investment income is defined to include gross receipts received from rents.

i. Self-employment income

A self-employment tax is imposed on net earnings from self-employment as defined by Code section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agrcultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity. Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income. In addition, eligibility for the earned income tax credit is determined by reference to the earnings from self-employment.[7]

j. Limitation on deduction of investment interest

In general, all interest paid or accrued during the taxable year on indebtedness is allowable as a deduction. However, if a taxpayer other than a corporation pays or accrues an amount of investment interest, then the otherwise allowable deduction with respect to

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[7] On Mar. 1, 1983, the Internal Revenue Service released questions and answers setting forth its position on the SECA tax treatment of Department of Agriculture farmland diversion payments, including payments of commodities received under the PIK program. Those questions and answers provide that a farmer who receives cash or a payment-in-kind from the Department of Agriculture for participation in a land diversion program is liable for self-employment tax on the payment. See, IR–83–89, Mar. 1, 1983.

that interest cannot exceed $10,000 ($5,000 in the case of a separate return by married individual), plus net investment income (Code sec. 163).

Investment interest is interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Net investment income means gross income from interest, dividends, rents, and royalties, and certain other items of passive income, to the extent it exceeds investment expense. Investment expense means expenses deductible under certain provisions of the Internal Revenue Code directly connected with the production of investment income.

k. Imposition of tax on unrelated business income of charitable, etc. organizations

A tax is imposed for each taxable year on the unrelated business taxable income of certain exempt organizations. The term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business. In general, all rents from real property are excluded from the computation of unrelated business taxable income.

l. Imposition of personal holding company tax

A tax in addition to the regular corporate income tax is imposed on the undistributed personal holding company income of every personal holding company. This tax is equal to 50 percent of the undistributed personal holding company income.

In general, a personal holding company is any corporation, other than certain specified types of corporations, at least 60 percent of the adjusted ordinary gross income of which is personal holding company income. In addition, more than 50 percent in value of the outstanding stock of a personal holding company must be owned, directly or indirectly, by 5 or fewer individuals during the last half of the taxable year. The term "personal holding company income" includes adjusted income from certain rents and royalties.

2. Income tax treatment of cooperatives

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a non-qualified written notice of allocation. In addition, a cooperative may exclude from gross income amounts attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.

Patronage dividends (whether paid in cash, qualified written notices of allocation, in redemption of nonqualified written notices of allocation, or in other property other than nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patron-

age dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.[8] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income or income derived from the sale or exchange of capital assets is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of 8 percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

3. Estate tax treatment of farmers

a. Current use valuation of certain farm real property

Qualification of decedent's estate

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, real property used in family farm operations and other closely held businesses may be included in a decedent's estate at its current use value, rather than its full fair market value. The maximum reduction in value permitted under the current use valuation provision is $750,000 per estate (Code sec. 2032A).

One of the requirements for specially valuing property is that minimum percentages of the decedent's estate must consist of real property which, among other attributes, has been used in a "qualified use" during certain specified periods. First, at least 50 percent of the adjusted value[9] of the decedent's estate must consist of the adjusted value of real and personal property used in a qualified use on the date of the decedent's death. Second, at least 25 percent of the adjusted value of the decedent's estate must consist of the adjusted value of real property used in a qualified use on the date of

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[8] A patronage dividend must be payable (1) on the basis of the quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

[9] The adjusted value of a decedent's estate is equal to the gross value of the estate minus indebtedness payment of which is secured by property in the estate. Similarly, the adjusted value of an asset is equal to the gross value of the asset minus indebtedness payment of which is secured by the asset.

the decedent's death and for periods aggregating at least 5 years of the 8-year period ending on the date of death. Third, all real property to be specially valued must have been used in a qualified use on the date of the decedent's death and for periods aggregating 5 years of the 8-year period ending on that date.

Another requirement is that the decedent or a member of his or her family must materially participate in the farming operation in which the real property to be specially valued is used. Material participation generally must occur during periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death. A special rule for individuals who are retired or disabled on the date of their deaths permits the material participation requirement to be satisfied by disregarding periods after the individuals began receiving social security benefits or became disabled, if the retirement or disability was continuous until the date of death.

Recapture of tax savings in certain circumstances

If, within 10 years [10] after the death of the decedent (and before the death of the heir receiving the property), specially valued property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purpose based upon which it was valued in the decedent's estate (i.e., its "qualified use"), all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" or "recapture tax." During the recapture period, the qualified use requirement must be satisfied at all times.[11]

The recapture tax is imposed on the qualified heir rather than the decedent's estate. However, the tax liability is measured by reference to the estate tax saved by the decedent's estate. In the case of a partial cessation of qualified use, the recapture tax is prorated based upon the percentage of the specially valued property that is no longer used in the qualified use.

Material participation in the farm operation is also required during the recapture period. Except in the case of "eligible qualified heirs," [12] the heir receiving the property or a member of the heir's family must materially participate in the farm operation for periods aggregating at least 5 years of every 8-year period ending after the date of the decedent's death and before expiration of the recapture period. Failure to satisfy the material participation requirement during the recapture period is deemed to be a cessation of qualified use.

Definition of qualified use

The term qualified use has the same meaning under both the pre-death reguirement and the recapture period requirement. In

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[10] The recapture period is 15 years in the case of estates of decedents who died before 1982.

[11] A special rule disregards a period beginning on the decedent's date of death and ending not more than 2 years later; however, the recapture period is extended by a period equal to any part of this 2-year period when the qualified use requirement is not satisfied.

[12] An eligible qualified heir can satisfy the material participation requirement through "active management," a lesser standard of personal involvement than material participation. Eligible qualified heirs include surviving spouses, minors, full-time students, and disabled individuals.

general, a qualified use is a use in farming or in another closely held business. The business in which specially valued real property is used must be an active operation, as opposed to a passive investment activity. In the case of farms, the activity requirement is normally satisfied by the production of crops or raising of animals for profit.[13]

Additionally, the decedent or a family member during pre-death periods) and each qualified heir owning a present interest in the property (during the recapture period) must own an equity interest (i.e., be at risk) in the business operation. The element of risk must be as to both price and production. Thus, for example, the qualified use requirement is not satisfied during any periods when the party who is to satisfy that requirement withdraws the property from productive use [14] or leases the property pursuant to a net cash or other fixed return lease.

Because real property is withdrawn from crop production under the payment-in-kind ("PIK") program in exchange for a fixed payment, such real property may not be considered to be used in a qualified use.[15]

Definition of material participation

Material participation means personal involvement in an active farming operation to a material degree. The determination of whether this requirement is satisfied is factual and is based on factors such as participation in making business decisions, inspection of crops, and other farm activities in which the participant engages.

Material participation for purposes of the current use valuation provision is defined by reference to the meaning of the same term as used in the social security tax provisions. Therefore, the participant's activity must be sufficient to convert his or her income from "passive rentals" to "earned income" for purposes of the self-employment income (SECA) tax. As earned income, the farm income is subject to the SECA tax. In addition, for certain persons under age 70, social security benefits may in some cases be reduced if this income exceeds prescribed amounts.

It is unclear under present law whether management of real property withdrawn from production under the PIK program requires sufficient personal involvement to constitute material participation.[16]

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[13] A so-called "hobby farm" which is an activity not engaged in for profit under Code section 183 does not satisfy the qualified use requirement (Treas. Reg. sec. 20.2032A/3(b)(1)).

[14] Property permitted to lie follow during nonproducing seasons or as part of a regular crop rotation program is treated as satisfying the requirement during these temporary periods.

[15] On Mar. 1, 1983, the Internal Revenue Service released questions and answers setting forth its position on the estate tax consequences of participation in Department of Agriculture farmland diversion programs, including the PIK program, under present law. These questions and answers provide that real property withdrawn from production under such farmland diversion programs is used in an active farming (i.e, qualified) use as required under the current use valuation provision. See, IR–83–39, Mar. 1. 1983.

[16] On Mar. 1, 1983, the Internal Revene Service released questions and answers which provide that, under present law, participation in the use to which real property diverted from production under Department of Agriculture land diversion program and in the devotion of such land to conservation purposes under such program satisfies the material participation requirements of the current use valuation provision. See, IR–83–39, Mar. 1, 1983.

b. Installment payment of estate tax

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if at least 35 percent of the value of the decedent's adjusted gross estate is comprised of the value of an interest in the closely held business and if certain other requirements are satisfied, payment of estate tax attributable to the interest in the closely held business may be extended and paid in installments during up to 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest). The determination of whether the decedent owns an interest in a closely held business is made as of the decedent's date of death (Code sec. 6166).

A special 4-percent interest rate is provided for estate tax attributable to the first $1 million in value of the closely held business interest (Code sec. 6601(j)). Tax in excess of this amount ($345,000 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (Code sec. 6601(a)). The regular deficiency rate currently is 16 percent.

Under present law, proprietorships owned by the decedent may qualify as an interest in a closely held business. In addition, an interest in a closely held business may include interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied.

Definition of trade or business

Only interests in active trades or businesses, as contrasted to passive investment assets, are eligible for the installment payment provision. The determination of whether an interest in an active trade or business is present is factual and must be made on a case-by-case basis.[17]

In Revenue Ruling 75–366, 1975–2 C.B. 472, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The Internal Revenue Service ruled that the decedent was in the business of farming under these facts stating:

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case, the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.

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[17] On Mar. 1, 1983, the Internal Revenue Service released questions and answers which provide that, under present law, real property diverted from production under any Department of Agriculture farmland diversion program, including the PIK program, is used in an active farming use for purposes of the installment payment provision. See, IR–83–89, Mar. 1, 1983.

> Accordingly, the farm real estate included in the decedent's estate qualifies . . . as an interest in a closely held business. (*Id.*)

Reasons for Change

The committee believes that farmers should not be discouraged from participating in the 1983 PIK program merely because of potentially adverse income and estate tax consequences. Therefore, the committee has acted expeditiously to afford relief in light of the brief time remaining for farmers to make decisions on participation in the program. The committee does not intend, however, that its expeditious action be construed to imply its future concurrence in such treatment or its opinion on the merits of the PIK program.

The committee determined that it should adopt the special tax treatment provided under the amendment only for the 1983 crop year. The committee made this decision because of the very brief time in which it had to consider the issues presented by the PIK program and the lack of sufficient data available to the committee on the allocation of benefits under the program. The committee believes a Treasury study of the PIK program and the tax treatment afforded participants in the program is essential in order to provide Congress with data with which to evaluate whether an extension of the bill's favorable tax treatment beyond the 1983 crop year is appropriate (assuming the Department of Agriculture extends the PIK program beyond this year).

Accordingly, the committee believes that an exception to the present rules relating to the timing of income recognition should be provided for taxpayers who receive commodities under the 1983 payment-in-kind programs. Taxpayers who receive such commodities should not be required to recognize the income from such receipt until the commodities are sold, at which time the sale proceeds would be available to the taxpayer to pay the applicable income taxes.

The committee also believes that the farmer should be treated as the producer of the commodity for all provisions of the Code and the Social Security Act. In particular, the farmer should be treated as the producer for all such provisions which relate to income from the trade or business of farming, to the characterization of income as passive or an activity as one not engaged in for profit, and to special estate tax treatment provided for property used in active farming businesses.

The committee is concerned, however, that the greatly reduced involvement required to manage property in the PIK program may encourage taxpayers to speculate in farm real property. To discourage such passive investment in farm real property primarily to receive the special tax treatment provided by the bill, the committee has adopted an anti-speculation rule that generally limits the provisions of the amendment to persons owning PIK property on February 23, 1983.

Explanation of Provisions

1. Income tax provisions (secs. 2 and 3 of the bill)

a. Income tax treatment of farmers

The committee bill provides that a qualified taxpayer will not be treated as having realized income when he or she receives, or has the right to receive, a commodity under a 1983 payment-in-kind program. Thus, both accrual and cash basis taxpayers can defer the recognition of income that would otherwise be recognized under current law in the year the commodities are received, until the year the commodities are sold, exchanged, or otherwise disposed of.

For purposes of determining the gain or loss from the sale, exchange or other disposition of the commodity, the unadjusted basis of the commodity will be zero. The commodity will be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity.

In cases where a CCC loan is involved, the committee understands that the payment-in-kind of a commodity to a taxpayer is to be achieved by a 3-step process: the repayment by the taxpayer of the loan from the CCC, the purchase by the CCC of the commodity securing the loan at the redemption price of the loan, followed by the receipt of the commodity by the taxpayer as a payment-in-kind. In any such case, the taxpayer who receives the commodity as payment-in-kind (in the third step of this 3-step process) will be entitled to the same tax treatment on such receipt as a taxpayer who receives a payment-in-kind where a CCC loan is not involved.

If the taxpayer has made an election under section 77 to recognize income in the year the CCC loan proceeds were received, the repayment of the loan and the purchase by the CCC of the commodity (the first and second steps of the 3-step process) will be treated by the taxpayer as a purchase of the commodity at an amount equal to the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and would recognize in income an equal amount which represents the difference between then outstanding balance of the loan and the taxpayer's basis.

In the case of a taxpayer who has not made an election under section 77, the repayment of the CCC loan and the purchase by the CCC of the commodity securing the loan (the first and second steps of the 3-step process) will be treated by the taxpayer as a repayment of the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and will recognize in income an amount equal to the then outstanding balance of the loan.

A qualified taxpayer is any taxpayer who meets the following two requirements. First, the taxpayer must be a producer (as defined in the Department of Agriculture regulations) of agricultural commodities within the meaning of the 1983 payment-in-kind pro-

gram. The committee understands that a taxpayer could be considered a producer of more than one crop under the 1983 PIK program. Second, the taxpayer must divert farm acreage from production and devote such acreage to conservation uses in return for receiving any commodity under the 1983 payment-in-kind programs.

The committee understands that, for purposes of the requirement that a person divert acreage from production and devote such acreage to conservation uses, the term "person" includes not only the person who actually diverts the acreage from production (such as a land owner) but also any other producer who receives a payment-in-kind with respect to such acreage (such as a sharecropper).

Under the committee bill, income from the sale or exchange of any PIK commodity will be subject to the tax on net earnings from self-employment for any individual who materially participates in the diversion and devotion to conservation uses of the PIK program.

Under the committee bill, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities will be treated as income from the trade or business of farming and the taxpayer will be treated as using in the trade or business of farming any land diverted from production under a 1983 PIK program. Thus, income with respect to the sale or exchange of commodities received under a 1983 PIK program will be treated as gross income from farming for all purposes of the Code, including (but not limited to):

(1) payments of estimated tax;

(2) method of accounting by corporations engaged in farming;

(3) expensing of certain soil and water conservation expenditures;

(4) expensing of certain expenditures by farmers for fertilizer;

(5) expensing of certain expenditures by farmers for clearing land;

(6) deductibility of expenses attributable to activities not engaged in for profit;

(7) gain from disposition of property used in farming or farm losses offsetting farm income;

(8) qualification of corporations for subchapter S status;

(9) application of self-employment tax;

(10) limitation on deduction of investment interest;

(11) tax on unrelated business income of charitable, etc., organizations; and

(12) tax on personal holding companies.

b. Income tax treatment of cooperatives

The Secretary of the Treasury (or his delegate), after consultation with the Secretary of Agriculture, is authorized to prescribe such regulations as may be necessary to carry out the purposes of the committee bill where a commodity is received by a cooperative on behalf of a qualified taxpayer. The committee intends that these regulations in all cases will treat PIK commodities marketed on behalf of a member or patron who is a qualified taxpayer as (1) produced by that member or patron in his or her business of farming and (2) received by the cooperative from the member or patron.

Thus, if a cooperative receives a payment-in-kind under a 1983 payment-in-kind program directly from the Commodity Credit Corporation (CCC) on behalf of a member or patron (because the member or patron assigned his right to receive the payment to the cooperative or because the member or patron was required to receive the payment through his or her cooperative), the income from the sale or other disposition of such commodities will be treated as patronage source income (unless there is no duty to allocate the income from such sale or other disposition on a patronage basis). Similarly, income derived by a cooperative from marketing any commodity which was first received by a member or patron under a 1983 PIK program and then sold or assigned to the cooperative also would be treated as patronage source income (unless there is no duty to allocate the income from such sale or other disposition on a patronage basis).

The effect of these regulations, therefore, will be to treat income received from marketing PIK commodities as deductible or excludible patronage source income to both exempt and nonexempt cooperatives (unless there is no duty to allocate the income from such sale or other disposition on a patronage basis). Further, under these regulations, the exemption of exempt farmers' cooperatives will not be endangered by marketing PIK commodities.

The committee intends that these regulations will provide that, if a cooperative markets PIK commodities received or acquired other than from or on behalf of a qualified taxpayer, the proceeds of the sale or other disposition of such commodities will be treated as any other non-patronage source income. Thus, if a creditor acquires a PIK commodity (or the right to receive a PIK commodity) in a foreclosure or similar event, or an investor purchases such a commodity (or the right to receive such a commodity), and then markets that commodity through a cooperative, the proceeds of the sale or other disposition of such commodity will not be considered patronage source under those regulations.

The committee further intends that, where a cooperative has a CCC loan outstanding and is required, as a condition to its participation in the PIK program, to pay off all or a portion of such loan and to sell the commodity which had been pledged as security for that loan to the CCC for the amount of loan, the transaction will be characterized as the repayment of the loan followed by a sale of commodity (regardless of whether or not a section 77 election has been made). Further, any income realized on such sale or other disposition of such commodity will be considered patronage source income only if the commodity which was security for the CCC loan would have generated patronage source income if sold.

c. Effective date

These provisions apply to PIK payments received with respect to real property withdrawn from production during the 1983 crop year. The 1983 crop year means, for these purposes, payments with respect to all crops normally harvested or planted on or before December 31, 1983.

2. Estate tax treatment of farmers (sec. 3 of the bill)

a. Current use valuation (Code sec. 2032A)

The committee bill provides that real property removed from production under a 1983 PIK program will be treated as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision. This rule will apply in determining whether the following requirements are satisfied:

(1) The requirement that at least 50 percent of the adjusted value of a decedent's estate consist of the adjusted value of real and personal property used in a qualified use on the date of the decedent's death;

(2) The requirement that at least 25 percent of the adjusted value of a decedent's estate on the decedent's date of death and consist of real property used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death;

(3) The requirement that all property to be specially valued be used in a qualified use on the date of the decedent's death and during periods aggregating at least 5 years of the 8-year period ending on that date; and

(4) The requirement that heirs inheriting specially valued real property use it in the qualified use based upon which it was specially valued continuously throughout a 10 (or 15) year recapture period.

The committee bill also provides that, in the case of property removed from production under a 1983 PIK program, the material participation requirements of the current use valuation provision will be satisfied if an individual otherwise required to materially participate in the active farming use of specially valued real property materially participates in the conservation use to which the property is devoted.

b. Installment payment of estate tax (Code sec. 6166)

The committee bill provides that real property withdrawn from production under the 1983 PIK program that was used in the conduct of an active trade or business before being so withdrawn will be treated as used in such trade or business. Therefore, in determining whether at least 35 percent of the value of an individual's adjusted gross estate consists of the value of an interest in a closely held business, real property withdrawn from production under the 1983 PIK program will be treated as used in the closely held business. Similarly, such property will be treated as used in an active trade or business in determining whether an individual's interest in such a business is an interest in a closely held business within the meaning of the installment payment provision.

In adopting these rules, the committee does not intend generally to change the present law rules governing the type of business which constitutes an active trade or business under the installment payment provision. Instead, the provisions of the committee bill merely treat real property withdrawn from production under the 1983 PIK program which is part of a business that otherwise qualifies for the installment payment provision as continuing to be used in such business.

c. No. inference as to diversion programs other than programs involving a payment-in-kind

These estate tax provisions of the committee bill apply only to real property withdrawn from production under the 1983 PIK program, i.e., a program under which a payment of commodities is made. The committee is aware that the Federal Government also conducts other farm real property diversion programs. The committee understands that, at the present time, these other programs either provide for cash payments in exchange for withdrawal of the property from production or require withdrawal of the property from production as a condition of eligibility for price support payments.

The committee intends that no inference be drawn that real property diverted from production under other Federal Government farmland removal programs is, or is not, used in the active business of farming from the fact that the committee bill only applies to real property withdrawn from production under the 1983 PIK program.

d. Effective date

As stated above, special rules which treat real property withdrawn from production under the 1983 PIK program as satisfying the qualified use and material participation requirements of the current use valuation provision apply only to real property withdrawn from production during the 1983 crop year. The provision relating to the installment payment provision also applies only to property withdrawn from production during the 1983 crop year. For these purposes, the 1983 crop year means payments with respect to all crops normally harvested or planted on or before December 31, 1983.

3. Anti-speculation rule (sec. 4 of the bill)

The committee bill provides a special anti-speculation provision which generally limits application of the special estate tax and income tax treatment accorded interests in real property withdrawn from production under the 1983 PIK program and commodities received with respect to such interests to persons who owned the property on February 23, 1983.

Interests in real property acquired after February 23, 1983, and commodities received with respect to such interests, will remain eligible for the special income and estate tax treatment if—

(1) The interest is acquired by reason of death of the person who owned the interest on February 23, 1983;

(2) The interest is acquired by gift from the person who owned the interest on February 23, 1983;

(3) The interest is acquired from the person who owned it on February 23, 1983, by a person who is a member of the transferor's family; or

(4) The interest is acquired from a person who received it in a transfer described in one of the above paragraphs, and, the current transfer also meets those requirements except for the fact that the current transferor did not own the interest on February 23, 1983.

For purposes of the third exception, the term "family member" includes a person's spouse, lineal descendants and their spouses, ancestors, and lineal descendants of the person's parents and the spouses of such lineal descendants (i.e., the definition of family member under the current use valuation provision (Code sec. 2032A)).

In addition, transfers that are mere changes in the form of ownership will be exempt from the anti-speculation rule. Under this provision, an interest in property will not be treated as transferred in the case of non-taxable transfers to corporations (Code sec. 351) or to partnerships (Code sec. 721) if the person owning the interest before the transfer retains a direct or indirect ownership interest equal to at least 80 percent of the trade or business after the transfer.[18] For example, an individual could incorporate his or her farming operation, including real property withdrawn from production under the 1983 PIK program, without losing the benefits of the special tax treatment provided by the committee bill, provided the person owns, directly or indirectly, at least an 80-percent interest in the corporation after the transfer.

The committee anticipates that the Treasury Department will issue regulations or rulings providing similar treatment for interests in real property distributed in a non-taxable liquidation of a corporation or partnership.

Should the transferor divest himself or herself of the minimum required interest in the PIK property at any time after the transfer, which constitutes a mere change in form, however, eligibility for the special tax treatment provided under the amendment would terminate.

The anti-speculation rule is applied on a taxpayer-by-taxpayer basis. For example, if a person who owned an interest in real property withdrawn from production under the 1983 PIK program sells the property to an unrlated party, the special tax treatment provided under the committee bill will not be available with respect to any portion of commodities received under a 1983 PIK program. If, however, a property owner whose property is under lease to a tenant who is also entitled to receive commodities under the 1983 PIK program, only those commodities to which the transferor-property owner is entitled will be excluded from special treatment under the bill.

In cases where a person acquires a direct or indirect 80-percent interest in a crop from real property, the person will be treated as acquiring the real property for purposes of the anti-speculation rule.[19] Thus, if after February 23, 1983, a property owner leases real property withdrawn from production under the 1983 PIK program to a tenant who is entitled to 80 percent of the PIK payment from the property, the tenant will be treated as acquiring the PIK real property. Therefore, the special tax treatment provided by the

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[18] The committee intends that the Treasury Department will develop rules for determining when an interest in real property is treated as indirectly owned. The committee anticipates that these rules will be similar to the related party rules presently contained in Code section 267, except that family membership will be determined under the definition of member of the family contained in the anti-speculation rule (i.e., the current use valuation definition).

[19] Rules identical to those for determining attribution of ownership of real property itself will apply in determining indirect ownership of a crop.

committee bill will not be available for interests in real property or PIK commodities received with respect thereto. If, however, the tenant's portion of the PIK payment were 60 percent, both the real property and the PIK commodities would remain eligible for the special treatment provided under the bill.

4. Treasury study (sec. 6 of the bill)

The committee bill requires the Secretary of the Treasury (after consultation with the Secretary of Agriculture) to conduct a study on the 1983 PIK program and the tax treatment accorded participants in the PIK program by the committee bill. The committee intends that the study include an analysis of the relative benefits accorded PIK participants by income class and by actual dollar amounts received for different crops. The committee expects that the study will address the relative income and tax benefits of the PIK program as compared to income and tax benefits that would have been received by owners of farm property had actual crop production occurred.

In addition, the committee intends that the study include an analysis of the cost-effectiveness of the PIK program as compared to other types of agricultural support programs, and also any effect that farmland diversion programs in general have on the cost-benefit analysis of other Federal Government programs, such as reclamation projects, which are frequently justified in part as increasing the amount of arable land available for farming.

Revenue Effect

If H.R. 1296 is measured against a baseline that includes both the outlay reductions and the revenue increases that will result from the PIK program, it is estimated that the provisions contained in the bill, H.R. 1296, as amended, will reduce fiscal year budget receipts by $323 million in 1984, $81 million in 1985, and increase budget receipts by $404 million in 1986. If H.R. 1296 is measured against a baseline that does not include the effects of PIK, the baseline in use by the committee at the time the bill was ordered reported, it would have no effect on revenues, since it averts a revenue increase not included in the baseline.

B. Treatment of Certain Agricultural Organizations (Sec. 5 of the bill)

Present Law

Under present law, certain labor, agricultural, or horticultural organizations are exempt from the income tax. (Code sec. 501(c)(5)). Agricultural organizations exempt under this provision are ones with respect to which (1) no net earnings enure to the benefit of any member, and (2) have as their object the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products and the development of a higher degree of efficiency in their respective occupations (Treas. Reg. sec. 1.501(c)(5)-1). Such organizations are taxable on their unrelated business taxable income (Code secs. 511-515).

If an organization which would otherwise qualify as one described in section 501(c)(5) engages in the performance of direct business services for its members (such as a processing, packaging, and marketing services), in exchange for a fee, then the Internal Revenue Service takes the position that the organization will not qualify as an exempt labor, agricultural, or horticultural organization. In such a case, the Internal Revenue Service believes that the organization is functioning more as a business for profit than for the betterment, improvement or increased efficiency of its members. Compare, Rev. Rul. 76-399, 1976-2 C.B. 152, with Rev. Rul. 74-195, 1974-1 C.B. 135.

Reasons for Change

The National Farmers Organization (NFO) is an agricultural organization formed to represent farmers as a collective bargaining agent. The NFO functions similarly to many labor unions. While labor unions attempt to secure higher wages and better working conditions for their members, the NFO seeks to obtain higher prices and more orderly markets for its members. However, the business of farming requires that the NFO must provide a wider range of services to its members than is often provided by labor unions. The Subcommittee believes that the provision of these limited services does not alter the essentially exempt purpose of the NFO. However, the committee believes that exemption should not be allowed if the NFO provides significant commodity processing services similar to those engaged in by regular businesses or if the organization owns significant assets such as assets used for the storage or transportation of commodities.

Explanation of Provision

Under the committee bill, any organization, which was organized as an agricultural organization in 1955 and was ruled exempt from

tax by the Internal Revenue Service under section 501(c)(5) in 1957, will qualify as an organization described in section 501(c)(5) if it meets certain requirements. In addition, any affiliate or unit of such an organization will qualify as an organization described in section 501(C)(5), if it meets these requirements regardless of when organized or if previously held exempt. First, the organization (or any affiliate or unit) must be operated on a non-profit basis primarily for the purpose of functioning as a collective bargaining agent for its members with respect to the sale of unprocessed agricultural commodities produced by its members. Second, the organization (or any affiliate or unit) must not substantially process the commodities which it markets. Third, such organization, (or any affiliate or unit) must, in its marketing activities, (1) act solely as an agent for its members and (2) return at least 90 percent of the sale proceeds (when it receives such proceeds from the purchaser) to its members in cash. If an organization qualifies under this provision, income earned in the performance of these functions will not be treated as unrelated to the organization's exempt function.

An organization is operated on a non-profit basis if it does not operate for the purpose of earning a profit and if no earnings of the organization (other than through the provision of services contemplated by the committee bill) inure to the benefit of any member.

Whether or not an organization (or any of its affiliates of units) engages in substantial processing activities is a facts and circumstances question. However, the performance of certain basic services, such as sorting and grading commodities, or performing services required by law before a particular commodity (such as milk) can be wholesaled in bulk, would not be considered substantial processing within the meaning of this provision.

The committee bill requires that, in carrying out its sole function as an agent, such organization (or any of its affiliates or units) will perform only such services as are necessary to carry out its collective bargaining activities. An organization (or any of its affiliates or units) is not operated solely as an agent within the meaning of this provision if it takes title to the commodities it is marketing. In addition, an organization (or any of its affiliates or units) does not function solely as an agent if it provides services (such as storage, transportation, or processing facilities) through the use of significant assets owned (or leased under long term leases) by the organization (or any of its affiliates or units).

The beneficiary of this provision is intended to be the National Farmers Organization.

Effective Date

This provision is effective for taxable years beginning after December 31, 1983.

Revenue Effect

This provision is estimated to have a negligible effect on budget receipts.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 1296. If H.R. 1296 is measured against a baseline that includes both the outlay reductions and the revenue increases that will result from the PIK program, the committee estimates that the provisions contained in the bill, H.R. 1296, as amended, will reduce fiscal year budget receipts by $323 million in 1984, $81 million in 1985, and increase budget receipts by $404 million in 1986. If H.R. 1296 is measured against a baseline that does not include the effects of PIK, it would have no effect on revenues, since it averts a revenue increase not included in the baseline. The committee wishes to emphasize that at the time it considered H.R. 1296, the baseline did not include the effects of PIK.

The Treasury Department, using a higher level of participation, as projected by the Department of Agriculture, estimates this bill, H.R. 1296, will reduce fiscal year budget receipts by $476 million in 1984, $120 million in 1985, and increase budget receipts by $596 million in 1986.

Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 1296 as amended, was ordered favorably reported by voice vote.

IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clause 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 1296, as amended.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that the Subcommittee on Select Revenue Measures conducted a hearing on February 23, 1982, to determine whether there was a need to modify the tax treatment of farmers and cooperatives participating in the 1983 PIK program. The Subcommittee unanimously reported H.R. 1296, with an amendment, to the full committee on February 23, 1983. As a result of these oversight activities, the committee concluded that it is appropriate to enact the provisions contained in the bill.

New Budget Authority and Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Office on Budget Estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budgt estimates (as indicated in part III of this report) and submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., March 2, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with the Budget Act, the Congressional Budget Office has examined H.R. 1296, which would amend the tax laws to permit taxpayers to defer income tax payments on crops received under the Payment-In-Kind (PIK) program initiated by the Administration. Without this legislation, these crops could be treated as taxable income in the year received by farmers participating in the PIK program.

This bill does not provide for any new budget authority or any new or increased tax expenditures.

If H.R. 1296 is measured against a baseline that includes both the outlay reductions and the revenue increases that will result from the PIK program, CBO estimates that it will reduce income tax receipts by $323 million in fiscal year 1984 and $81 million in fiscal year 1985, and increase revenues by $404 million in fiscal year 1986. If H.R. 1296 is measured against a baseline that does not include the effects of PIK, it would have no effect on revenues, since it averts a revenue increase not included in the baseline.

If you would like additional information on this estimate, please let us know.

Sincerely,

JAMES BLUM
(For Alice M. Rivlin, Director).

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have a significant overall effect on prices and costs in the operation of the national economy, as the price maintenance aspects of the PIK program are expected to be offset by the income tax receipts from the sale of released surplus commodities and the reduction in budget outlays to store and maintain surplus commodities.

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